

COMMENT

STOCK REDEMPTION FUNDED BY LIFE INSURANCE

There are primarily two types of buy-sell agreements funded by life insurance.¹ The first is called an entity plan under which the corporation promises to buy and the shareholder obligates his estate to sell the stock owned by the decedent at the time of death.² This comment will deal primarily with this type of plan but will occasionally allude to the second type of plan, called the purchase agreement. In the usual cross-purchase agreement each shareholder purchases insurance on the life of the other shareholders and obligates himself to use the proceeds to purchase the interest of the others should they predecease him. The premiums may be paid either by the corporation or the shareholders individually.

Normally both types of agreements are funded by life insurance since this provides funds as soon as the corporation starts paying the premiums, and the policies purchased also have cash or collateral value. Because of the widespread use of life insurance in this area, the discussion which follows will center on agreements which have been so funded.

Under either the entity or the cross-purchase type plan, a trustee may be used. Typically the trustee, with whom the shareholders have deposited their stock, holds the insurance policies for the benefit of the estate of the insured. Upon the death of the shareholder-insured, the trustee collects the proceeds, pays them to the estate of the decedent, and turns the decedent's stock over to the purchaser under the agreement.³ At least one author has suggested that use of the trustee will prevent creditors of the decedent or of the prospective purchaser from

¹ For good discussions of stock redemption funded by life insurance see Friedman and Wheeler, Jr., "Stock Redemption Agreements Funded by Life Insurance," 37 Taxes 915 (1959); Lawthers, "Prunier Offers No Threat to a Sound Insured Buyout Plan," 7 J. Taxation 2 (1957); Manheimer and Friedman, "Stock-Retirement Agreements—The Prunier and Sanders Cases," 35 Taxes 567 (1957); Margolis, "Income Tax Aspects of Executive-Stockholder Life Insurance Plans," N.Y.U. 19th Inst. on Fed. Tax 69, 76 (1961); Worthy, "Current Developments in Federal Taxation Affecting Life Insurance," A.B.A. Sect. Ins. N. and C. L. 142 (1958).

² See Teske & Maier, "Stock Retirement Agreements Resurrected or the 'Tax Collector's Bark Is Often Worse Than His Bite,'" 41 Marq. L. Rev. 358 (1957). In an appendix to this article the authors set out a suggested form to be used as a guide in drafting stock-purchase agreements of the entity variety.

³ Sample trustee stock purchase plans can be found in I. Rabkin and Johnson, *Current Legal Forms With Tax Analysis*, 927-69, 1600-66 (Supp. 1955).

reaching the policy, its proceeds or the stock so long as it is in the hands of the trustee.⁴

However, a transfer of an insurance policy in trust, for the sole purpose of collecting and distributing the proceeds to the stockholder, would be dividend income to the stockholder measured by the cash surrender value of the policies at the time of the transfer.⁵ This result may be avoided if the corporation retains certain incidents of ownership in the policy, such as the receipt of policy dividends, the right to change the beneficiary, and the right to sell or hypothecate the policy.⁶

DETERMINATION OF PURCHASE PRICE

Once it is decided to enter a stock purchase agreement funded by life insurance, a method for determining the price to be paid for the stock at death must be adopted.⁷ A fixed price will not take account of future fluctuations in the value of the stock so that it may be wise to provide for changes at certain intervals subject to arbitration if the parties fail to agree. If a fixed price is not set, provision should be made regarding who is to pay any excess above the insurance proceeds and who is to get the excess insurance proceeds in the event the final price set is less than the proceeds from the insurance.⁸ Perhaps the most common method of fixing the purchase price in a stock purchase agreement funded by life insurance is the formula method. Under this type of plan the purchase price is normally based upon the book value of the stock on a certain date. If book value is used, the parties should carefully specify what is meant by book value and the date as of which book value is to be computed. Another problem inherent in the book value formula is whether or not the insurance proceeds are to be included in the book value. Failure to include the insurance proceeds in book value may result in great inequities to the estate of the deceased shareholder particularly in the case of a premature death when the proceeds received by the corporation are much greater than the asset value of the insurance policy on

⁴ See Laikin, "Settlement Options and Survivor-Purchase Agreements," 4 J. Am. Soc'y C.L.U. 199, 205 (1950). However, if the corporation is insolvent the trust will become illegal in states where an insolvent corporation cannot redeem its own stock and corporate creditors would then be able to reach the insurance policy.

⁵ *Golden v. Commissioner*, 113 F.2d 590 (3d Cir. 1940).

⁶ *Ibid.*

⁷ For a discussion of this problem with citation of authorities see Comment, "The Use of Life Insurance To Fund Agreements Providing for Disposition of a Business Interest at Death," 71 Harv. L. Rev. 687, 690 (1958). See also Forster, "Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement," 4 Stan. L. Rev. 325 (1952).

⁸ Comment, 71 Harv. L. Rev. 687, *supra* note 7.

the corporate books. However, inclusion of the insurance proceeds in book value will result in an increase in the amount of insurance needed to fund the stock redemption agreement. In any event, only a proportionate share of the proceeds is included in the purchase price of the stock, based upon the decedent's share ownership.⁹

PURPOSES

There are certain very definite purposes served by stock redemption plans. A plan of this type assures continuity of the business without interference from new interests. Furthermore, a plan of this type guarantees the estate of the deceased shareholder a ready market for his stock at a price fixed by those having the greatest familiarity with the business.¹⁰ Another benefit to be derived from a plan of this nature is the fixing of the valuation of the stock for purposes of estate and inheritance taxes.¹¹ Also there is provided a definite fund with which to redeem the stock.

The remarks that follow will be applicable mainly to the closely held corporation where harmony of management can be so easily upset by the sale of stock to an outside interest. The buy-sell agreement is also used by partnerships, but the complex problems of the partnership area are not within the scope of this article.¹²

PAYMENT OF PREMIUMS AS TAXABLE INCOME TO STOCKHOLDER

In most cases it is impractical for the shareholders of a close corporation to pay for the life insurance needed to fund a stock-purchase agreement. The premiums on these policies are usually paid directly by the corporation because the main source of liquid assets to the shareholders is taxable dividend and compensation dollars. This all works out well as long as the premium payments by the corporation are not taxed to the shareholders on one theory or another.

At the outset it should be understood that premiums paid by the corporation for life insurance on the lives of its stockholders are not deductible by the corporation. The deduction is disallowed under

⁹ See Davis, "Business Purchase Agreements," 94 *Trusts & Estates* 284, 328 (1955).

¹⁰ For a discussion of the benefits of these plans see White, "Business Insurance," 87-90, 193-201, 434-40 (2d ed. 1956).

¹¹ See *Commissioner v. Bense*, 100 F.2d 639 (3d Cir. 1938); *Lomb v. Sugden*, 82 F.2d 166 (2d Cir. 1936); *Estate of Lionel Weil*, 22 T.C. 1267 (1954); *Estate of Ray E. Tompkins*, 13 T.C. 1054 (1949).

¹² See Int. Rev. Code of 1954, § 736 and the regulations thereunder dealing with the sale of a partnership interest. For a good discussion of the income tax aspects of the partnership entity plan see Comment, 71 *Harv. L. Rev.* 687, *supra* note 7, at 697. See also Egger, "Sales of Partnership Interests and Death or Retirement of a Partner," N.Y.U. 15th Inst. on Fed. Tax 115 (1957).

§ 264(a)(1) of the Internal Revenue Code if the corporation is either directly or indirectly a beneficiary under the policy. It will be necessary for the corporation to retain some interest in the insurance in order for the stockholder to avoid constructive dividend treatment on the premiums paid by the corporation so the corporation will be at least an indirect beneficiary and will lose the deduction.

Under the doctrine of constructive dividends, a stockholder must pay tax upon benefits which are equivalent to a corporate distribution of surplus. For example, if a shareholder borrows funds from the corporation with no intention of paying them back, the amount borrowed may be taxed as a constructive dividend.¹³ The mere fact that minority stockholders have not participated in the borrowing will not prevent the courts from finding a distribution in the nature of a dividend.¹⁴

Some of the early decisions in the insurance area used the constructive dividend theory to tax the corporate payment of premiums to the shareholder. In *Paramount-Richards Theatres Inc. v. Commissioner*¹⁵ a contract was entered into under which insurance was purchased at corporate expense on the life of a particular shareholder who was permitted to designate the beneficiaries of the policy in exchange for his promise that on his death his stock would become the property of the surviving shareholders. The court in that case held that each premium payment constituted a taxable dividend to the shareholder-insured.¹⁶

Other early cases held that corporate expenditures conferring tangible economic benefits upon an employee were intended to be compensation for services and thus taxable as such to the employee.¹⁷

¹³ *Chattanooga Savings Bank v. Brewer*, 17 F.2d 79 (6th Cir. 1927). See also *Allen v. Commissioner*, 117 F.2d 364 (1st Cir. 1941) and *Hadley v. Commissioner*, 36 F.2d 543 (D.C. Cir. 1929) to the same effect.

¹⁴ *Christopher v. Burnet*, 55 F.2d 527 (D.C. Cir. 1931). *Manheimer*, "Insurance To Fund Stock-Retirement and Buy-And-Sell Agreements," 341 Ins. L.J. 414 (1951) a constructive dividend was defined as follows: "Any disposition of corporate earnings other than a formal dividend distribution, which produces as to one or more shareholders, a result substantially the same as a formal dividend declaration."

¹⁵ 153 F.2d 602 (5th Cir. 1946). The court went on to say that by allowing the stockholder to designate the beneficiary the corporation surrenders sufficient control over the property to make it of direct benefit to the stockholder. See also *Casper Ranger Constr. Co.*, 1 B.T.A. 942 (1925).

¹⁶ For other decisions establishing that premium payments by a corporation on a life insurance policy on the life of a shareholder are income to the shareholder if he is permitted to designate the beneficiary and no benefit accrues to the corporation see *Burnet v. Wells*, 289 U.S. 670 (1933); *Noel v. Parrott*, 15 F.2d 669 (4th Cir. 1926); *N. Loring Danforth*, 18 B.T.A. 1221 (1930); *George M. Adams*, 18 B.T.A. 381 (1929); *Berizzi Brothers Co.*, 16 B.T.A. 1307 (1929).

¹⁷ *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929); *Chandler v. Com-*

This reasoning has also been applied to the corporate purchased insurance premium for the benefit of an employee of the corporation. If a corporation pays the premiums on insurance on one of its employee's life, the employee has the sole right to appoint the beneficiary, and the corporation does not have any interest in the policy, the payment of each premium represents taxable compensation to the employee.¹⁸

In 1957 and 1958 three court of appeals cases were decided in this area, two reversing the Tax Court and the other reversing a district court. All three cases arrived at the conclusion that the corporate payment of premiums for life insurance on the life of a shareholder is not taxable income to the shareholder. The three cases have done much to clarify the law in this area and thus merit individual attention.

*Casale v. Commissioner*¹⁹ involved a deferred compensation agreement funded by life insurance on the life of the president and owner of 98% of the stock of a corporation. On the same day the deferred compensation agreement was made the corporation applied to an insurance company for a \$50,000 life policy insuring the president's life for the benefit of the corporation, and the insurance company later issued the policy providing for an annual premium payment of \$6,839.50. The policy also provided that the corporation was the owner of the policy and entitled to death benefits under it and that on maturity of the policy thirteen years later when the president reached 65, he should receive a monthly income payment of \$500 for life or for a ten-year period whichever was longer. The corporation had the right to assign the policy, to change the beneficiary, to receive dividends, and to borrow on the policy. The Tax Court held that in view of the insured's complete domination of the company, retention by the corporation of various policy rights was meaningless, and that the real benefit of the policy flowed immediately to the insured so that the premiums at the time of payment should be taxed to him as dividends.²⁰ The Second Circuit Court of Appeals reversed the Tax

missioner, 119 F.2d 623 (3d Cir. 1941) (taxpayer lived on corporate property without paying any rent); J. H. McEwen, 6 T.C. 1018 (1946) (corporation made contributions to trust fund set up to take care of taxpayer in his declining years).

¹⁸ *Commissioner v. Bonwit*, 87 F.2d 764 (2d Cir. 1937); *Yuengling v. Commissioner*, 69 F.2d 971 (3d Cir. 1934); *N. Loring Danforth*, *supra* note 16; *George M. Adams*, *supra* note 16.

¹⁹ 247 F.2d 440 (2d Cir. 1957).

²⁰ *Oreste Casale*, 26 T.C. 1020, 1025 (1956). The Tax Court stated:

"Considering the features of the policy in conjunction with the provisions of the compensation agreement, we must conclude that the corporation was no more than a conduit running from insurer to petitioner, or his beneficiaries, with

Court and held that the annual premium paid by the corporation was not a distribution by the corporation to the president of a taxable dividend in the year of payment. The court reasoned that the policy was a corporate asset subject to the claims of other creditors along with the insured, and, thus, the insured taxpayer received no immediate personal benefit but only a future contingent benefit. The opinion closed with the following words: "We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person."²¹

*Prunier v. Commissioner*²² involved a stock purchase agreement between two brothers and a corporation. Each brother was named as beneficiary in the policies on the life of the other and yet the proceeds were to be used to acquire the stock for the corporation. The brothers each retained the right to change beneficiaries. The Tax Court held that the surviving brother and not the corporation would be the real beneficiary and thus the premiums should be taxed as dividends when paid.²³ The Tax Court was again reversed, this time by the First Circuit Court of Appeals. This court reasoned that the real beneficial owner was the corporation since under the state law the corporation was entitled to the proceeds after paying the premiums even if the brothers were nominally the beneficiaries. The court recognized that corporate rights and benefits must be treated separately from stockholder rights and benefits for tax purposes.²⁴

*Sanders v. Fox*²⁵ involved a stock redemption agreement funded by life insurance. There were four stockholders in the corporation, and insurance policies were taken out on their lives nearly proportionate in amount to the corporate interest of each stockholder. The

respect to any payments which might come due under the insurance contract. Essentially petitioner stood in the same relationship to the policy as if he had taken it out himself and the corporation had paid the premiums for him. The similarity in terms between the policy and compensation agreement afford recourse to no other conclusion."

²¹ *Casale v. Commissioner*, *supra* note 19, at 445.

²² 248 F.2d 818 (1st Cir. 1957).

²³ *Henry E. Prunier*, 28 T.C. 19 (1957). The Tax Court reasoned that the corporation derived no benefit from the agreement in that its indebtedness to creditors remained undiminished. The Court felt that the entire benefit would be derived by the surviving brother whose proportional interest in the corporation would be greatly increased by the redemption of his brother's stock.

²⁴ The court relied upon the *Casale* case, *supra* note 19 as authority for its conclusion.

²⁵ 253 F.2d 855 (10th Cir. 1958).

policies were deposited with the corporation with all lifetime benefits reserved to the corporation and the corporation paid the premiums on the policies. Each shareholder deposited with the corporation his corporate stock, endorsed in blank but without surrender of the right to sell or vote the stock or receive dividends on it. The shareholder had the exclusive right to name the beneficiary of the insurance proceeds payable at death. On the death of a stockholder the corporation was to acquire his stock for a price to be fixed under a formula in the agreement, with the proceeds of the policy on such stockholder's life to be applied against such price. In no event was the designated beneficiary to receive less than the proceeds of the policy.²⁶ The district court held²⁷ that in effect the stockholders were the corporation, that benefits flowed to both the corporation and the shareholder from payment of the premiums, and that the premiums should be regarded as dividends. The Tenth Circuit reversed and held that payment of the premiums was not a constructive dividend to the shareholders. The court distinguished between the situation where a corporation pays premiums on a policy owned by the corporation, and the situation where a corporation pays premiums on a policy owned by the insured (who also designates the beneficiary); only in the latter case does payment of premiums constitute taxable income to the shareholder. The court found no present taxable benefit to the stockholders, pointing out that the stock must be given up in order for the beneficiary to receive the proceeds; the situation was just as if the corporation had agreed to pay a fixed amount on a stockholder's death to his nominee in exchange for the stock and had named itself as beneficiary of the policy.²⁸

The rationale of the three cases seems to be based upon the principle of ownership. As long as the corporation retains all the incidents of ownership in the policy the shareholder receives no benefit at the time premiums are being paid by the corporation. The policy is an asset of the corporation and is subject to the claims of creditors so that the shareholder enjoys only a future contingent benefit which should not be taxable when premiums are paid.

As pointed out previously, the stock redemption plan funded by life insurance has both corporate purposes and shareholder pur-

²⁶ For specific policy provisions see 263 F.2d 857, 858 (10th Cir. 1958).

²⁷ *Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957).

²⁸ It is true that because the stockholder is guaranteed a minimum sales price for the stock, the stockholder may ultimately benefit considerably from the policy and agreement, but the amount of gain, if any, can only be evaluated at that time. During the contemplated life of the policy, the only realizable value, the benefits accruing to the owner of the policy, is with the corporation.

Sanders v. Fox, *supra* note 25, at 861.

poses.²⁹ Whatever benefits a close corporation, however, is likely to also benefit its shareholders. At any rate it is now clear that the redemption of closely held corporate stock under stock purchase agreements, in the absence of special circumstances,³⁰ will be considered a genuine corporate activity furthering continuity of management and ownership.³¹

The Internal Revenue Service expressly approved the three previously discussed decisions in a 1959 ruling.³² It was stated in the ruling that the payment of premiums by the corporation is an independent act by the corporation by which it converts one asset into another asset and such action has no relationship to the receipt of taxable income by the shareholder.³³

²⁹ In *Emeloid v. Commissioner*, 189 F.2d 230, 233 (3d Cir. 1951) the court had this to say on the subject of corporate purpose:

Petitioner apparently anticipated that, should one of its key shareholder-officers die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate not being bound by contract to sell the stock to the petitioner, might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals.

³⁰ For cases where those special circumstances existed see *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947) (corporation merely fulfilling personal obligation of a shareholder); *Pelton Steel Castings Co. v. Commissioner*, 251 F.2d 278 (7th Cir. 1958); *George D. Mann*, 33 B.T.A. 281 (1935); *Ruphane B. Iverson*, 29 B.T.A. 863 (1934).

³¹ *Emeloid v. Commissioner*, *supra* note 29; *Edgar M. Docherty*, 47 B.T.A. 462 (1942); *Dill Mfg. Co.*, 39 B.T.A. 1023 (1939); *Fred F. Fischer*, 6 CCH Tax Ct. Mem. 520 (1947). Another argument which can be made, perhaps a bit less persuasively, in favor of the nontaxability of the premium payments is based upon the fact that the premium payments are not deductible by the corporation as ordinary and necessary expenses of doing business under section 162 of the Code.

³² Rev. Rul. 59-184, 1959-1 Cum. Bull. 65. The ruling states:

Where a corporation purchases life insurance on the lives of its stockholders, the proceeds of which are to be used in payment for the stock of stockholders, the premiums on such insurance do not constitute income to the stockholder, even though the stockholder has the right to designate a beneficiary, provided such right of the beneficiary to receive the proceeds is conditioned upon the transfer of the corporate stock to the corporation.

The decisions of the United States Courts of Appeals in the cases of *Casale v. Commissioner*, 247 F.2d 440, *Prunier v. Commissioner*, 248 F.2d 818, and *Sanders v. Fox*, 253 F.2d 855, involving similar factual situations, will be followed by the Internal Revenue Service.

³³ Rev. Rul. 59-184, 1959-1 Cum. Bull. 65, 66. In its hypothetical case the ruling sets up the provisions of a stock redemption agreement from which we find that the use of insurance to provide funds for the stock redemption may be included in the agreement. The insured may be given the right to purchase the insurance at its cash value in the event of a premium default by the corporation. Finally, we find that the stockholder insured may designate a beneficiary as long as the right of the beneficiary

The ruling contains several limitations which should be noticed by draftsmen. It states that in the case of cross-purchase agreements, where the stockholders are the owners and beneficiaries under the policies, premiums paid by the corporation, which is not even a party to the agreement, will be taxable income to the shareholders.³⁴ The ruling also states that the obligation to purchase the stock must be solely the obligation of the corporation and not the obligation of the shareholder taken over by the corporation.³⁵

The cases and the ruling seem to make clear what has to be done in order to avoid dividend treatment of premiums paid by a corporation on life insurance used to fund stock redemption agreements.³⁶

UNREASONABLE ACCUMULATION OF EARNINGS

Another pitfall to avoid is the penalty tax imposed under sections 531 to 537 of the Internal Revenue Code on corporations which unreasonably accumulate income in order to avoid taxes to the shareholders. Accumulation of income beyond the reasonable needs of the business will establish the purpose of avoiding income tax unless the corporation proves to the contrary by a preponderance of the evidence.³⁷

Will the carrying of insurance to fund buy-sell agreements be considered an unreasonable accumulation of income not related to the business needs of the corporation and thus subject the corporation

to receive the proceeds is conditioned upon his duty to transfer the stock to the corporation. These rights may be given the insured without risk of dividend treatment on the premium payments by the corporation.

The ruling also approved the trustee type of plan and said it would not be given dividend treatment on payment of premiums by the corporation.

³⁴ In support of this conclusion the ruling cites *Doran v. Commissioner*, 246 F.2d 934 (9th Cir. 1957).

³⁵ The ruling cites *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947) as support for the proposition that an individual is taxable when the corporation assumes his personal obligation.

³⁶ For a case involving the problem of constructive dividends in the key man insurance area, see *Ducros v. Commissioner*, 272 F.2d (6th Cir. 1959), *not acq.* Rev. Rul. 61-134 1961 Int. Rev. Bull., No. 29, at 20.

³⁷ Int. Rev. Code of 1954, § 533. Under section 534 the burden of proof is supposed to shift to the commissioner on the issue of unreasonable accumulation of income if the corporation has submitted a statement of the grounds on which it relies to establish that any part of the earnings were not permitted to accumulate beyond the reasonable needs of the business. The Tax Court has not followed this provision in the past. The recent case of *Gsell v. Commissioner* may, however, indicate a new trend.

Under section 531 the tax imposed is 27½% of the first \$100,000 of earnings unreasonably accumulated in the taxable year and 38½% on the excess.

Under section 535(c)(2) the corporation can accumulate \$100,000 over the years before it will be subject to attack by the tax authorities.

to the penalty tax under section 531? Previous cases have held that agreements for the redemption of stock serve a legitimate corporate purpose.³⁸ The *Pelton Steel Casting* case³⁹ suggests that "business needs" under section 531 may be a somewhat narrower concept than corporate purpose as established by the older cases not dealing with section 531.

In *Pelton* the corporation redeemed the stock of living shareholders owning 80% of the stock in the corporation making it more difficult to show that the acquisition served the purpose of continuity of management which is usually the case when the stock of a deceased stockholder is redeemed. The Tax Court, which was later affirmed by the court of appeals, emphasized the distinction between purchasing a majority interest and purchasing a minority interest.⁴⁰

The *Pelton* case should not be extended beyond its facts to the stock purchase agreements funded by life insurance. The latter type of agreements serve definite business needs such as continuity of management, improvement of employee morale, confidence of creditors, and avoidance of inexperienced ownership among others.⁴¹ If it is agreed that the stock purchase agreements are a "reasonable need" of the business, then the accumulation of earnings to finance the plan through the purchase of insurance policies should not be considered as an avoidance of taxes to the shareholders.

Actually the use of insurance to fund stock purchase agreements may decrease the risk of a penalty tax under section 531 since it is not necessary to accumulate as much income to provide for the contingency of a premature death when the corporation has insurance on the life of the stockholder as it is when the corporation must accumulate the cash to meet this contingency.⁴²

REDEMPTION PRICE AS DIVIDEND TO SURVIVING SHAREHOLDERS

In *Sanders v. Fox* the majority opinion closed with a rather foreboding comment: "Upon the death or withdrawal of a stockholder, tax complications, including the possibility of an assessment of construc-

³⁸ See cases cited *supra* note 31.

³⁹ *Pelton Steel Castings Co. v. Commissioner*, 251 F.2d 278 (7th Cir. 1958).

⁴⁰ *Pelton Steel Castings Co.*, 28 T.C. 153 (1957). The Tax Court distinguished prior cases such as *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (D.C. Ark., 1952) and *Dill Man. Co.*, 39 B.T.A. 1023 (1939), where stock of minority shareholders was redeemed to maintain the management policy of the majority and to prevent the sale of minority interests to outsiders.

⁴¹ *Manheimer and Friedman*, "Stock-Retirement Agreements," 28 *Taxes* 423 (1950).

⁴² For further discussion see, *Altman*, "Corporate Accumulation of Earnings," 36 *Taxes* 933 (1958).

tive dividends may arise, but the solution of these dimly-foreseen and nebulous problems must await a clearer view."⁴³

In the case of *Holsey v. Commissioner*⁴⁴ the taxpayer owned 50% of the outstanding stock of a corporation and had an option to purchase the other 50%. The taxpayer assigned the option to the corporation which redeemed the other 50%, thus making the taxpayer a 100% stockholder. There was no life insurance involved in this case, but the case is relevant for the purposes of this article because this type of agreement is often funded by life insurance. The Tax Court held that the redemption by the corporation was essentially equivalent to a dividend to the remaining stockholders on the ground that solely a personal purpose and not a corporate purpose was served by redemption of the stock.⁴⁵

The Third Circuit reversed the Tax Court and held that the redemption by the corporation was not a dividend to the remaining sole shareholder. The court reasoned that this case was distinguishable from a case where the corporation assumes an obligation of a shareholder because here the shareholder was never under any legal obligation to purchase the stock but merely had an option to purchase it.⁴⁶

In 1958 the Internal Revenue Service expressed approval of the court of appeals decision in the *Holsey* case.⁴⁷ The *Holsey* case and the ruling following it seem to reach the proper result, despite the fact that the proportionate interests of the remaining shareholders are increased, because the assets of the corporation have been reduced by the purchase of the stock.

⁴³ *Sanders v. Fox*, *supra* note 25, at 861.

⁴⁴ 258 F.2d 865 (3d Cir. 1958).

⁴⁵ *Joseph R. Holsey*, 28 T.C. 962 (1957). That purpose was to make the taxpayer the sole shareholder of the corporation.

⁴⁶ The court also stated that the percentage interest of the shareholder changed from 50% to 100% thus making this look different from the situation where a true dividend is paid and the proportionate interests remain unchanged. Finally the court agreed that the stockholder benefited indirectly by his increased proportionate interest in the corporation but said that this would not give rise to taxable income until the corporation makes a distribution to the stockholder or until his stock is sold.

⁴⁷ Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. The ruling stated that an increase in the proportionate interest of the remaining shareholder does not necessarily mean the redemption price will be taxable income to him.

The ruling closes with the admonition that there will be a gift or compensation to the remaining shareholders if the stock is purchased for less than fair market value. The court in the *Holsey* case did not explore this possibility even though the redemption was for less than book value. It would seem that the ruling restricts *Holsey* to this extent. The converse of this proposition is also true in that if the corporation pays more than the fair market value of the stock the result will be a compensation or a gift to the shareholder surrendering his stock.

A later ruling⁴⁸ has applied the reasoning of *Holsey* to stock redemption from the estate of a deceased stockholder. The ruling does not state that the plan was funded by life insurance but the principles are equally applicable to a plan funded by life insurance and thus are relevant for the purposes of this article. The ruling states that two brothers each owned 50% of the stock of a corporation. They entered a stock redemption agreement which provided that upon the death of either stockholder, the survivor would either purchase the stock of the deceased at its fair market value within six months, or vote his stock for dissolution and liquidation of the corporation. One of the brothers died and the other brother and the representative of the deceased brother decided to have the corporation purchase the shares held by the estate for business reasons. Since the surviving brother at no time possessed the shares of stock redeemed from the deceased brother's estate, the ruling concludes that a redemption by the corporation of the stock of the deceased brother from his estate did not constitute a constructive dividend to the remaining brother.

In the normal stock redemption agreement of the entity type, funded by life insurance, there will be no question that the corporation itself has the obligation to purchase the stock from the estate of the deceased stockholder, so it is clear that there will be no problem of dividend treatment to the surviving stockholder. The corporation in the ruling relieved the surviving shareholder of his personal obligation so that the ruling goes even further in disallowing dividend treatment than is necessary in the case of most stock purchase agreements funded by life insurance.⁴⁹

TAXABILITY OF SELLING STOCKHOLDER'S ESTATE

A redemption by the corporation will not result in ordinary income treatment to the estate which sells its stock to the corporation as long as any one of three requirements is met under section 302 of the Code. There will be ordinarily no tax to the estate⁵⁰ if the redemption is not essentially equivalent to a dividend,⁵¹ if the redemption is

⁴⁸ Rev. Rul. 59-286, 1959-2 Cum. Bull. 103.

⁴⁹ The ruling distinguished its own set of facts from the Wall case, *supra* note 35 on the ground that in the Wall case the taxpayer had purchased the stock of the other stockholder at the time his personal note was satisfied by the corporation in return for the stock.

⁵⁰ Int. Rev. Code of 1954, § 1001 provides for recognition of gain to the extent of the excess of the proceeds over the basis of the stock. But since the amount received will ordinarily fix the fair market value of the stock at date of death, which in turn fixes the basis of the stock in the hands of the estate under § 1014, the recognized gain will be zero.

⁵¹ Int. Rev. Code of 1954, § 302(b)(1).

substantially disproportionate,⁵² or if the redemption completely terminates the interest of the estate in the corporation.⁵³

There were many cases under the 1939 Code discussing when a redemption was "essentially equivalent to a dividend." The cases reveal that the redemption was not treated as "essentially equivalent to a dividend" where the corporation had a good business purpose for distributing its assets⁵⁴ or the result of the redemption was to change substantially the relative position of a stockholder in regard to the other stockholders.⁵⁵

It is assumed that the same tests for determining when a redemption is not essentially equivalent to a dividend apply under the 1954 Code except for the important change that the attribution rules of section 318 now apply to this part of section 302.⁵⁶ These tests lack clarity and it is felt by at least one writer that the importance of the section 302(b)(1) "essentially equivalent" requirement will be greatly diminished by the use of the clear requirements for capital gain treatment under section 302(b)(2) and (3).⁵⁷

Under section 302(b)(3) of the Code, as has been stated above, if a shareholder's interest in the corporation is completely terminated by the redemption of his shares, the receipt of the proceeds of the redemption will be treated as a sale or exchange of his stock. This is a clear test and the only obstacles to meeting it are the attribution rules of section 318 of the Code.⁵⁸

⁵² Int. Rev. Code of 1954, § 302(b)(2). There are primarily three requirements which must be met in order to escape dividend treatment on a redemption under the "substantially disproportionate" test. The proportionate share of the voting stock owned by the shareholder immediately after the redemption must be less than 80% of the proportionate share owned immediately before the redemption. The 80% rule applies also to the proportion of the common stock (voting and non-voting) owned by the shareholder immediately before and after the redemption. Finally, immediately after the redemption the shareholder must own less than 50% of the total combined voting power of all classes of stock entitled to vote.

There is also a fourth minor requirement under section 302(b)(2)(D) that the redemption is not one of a planned series resulting in the aggregate in a substantially disproportionate distribution.

⁵³ Int. Rev. Code of 1954, § 302(b)(3).

⁵⁴ *Commissioner v. Sullivan*, 210 F.2d 607 (5th Cir. 1954); *Commissioner v. Snite*, 177 F.2d 819 (7th Cir. 1949).

⁵⁵ *Commissioner v. Roberts*, 203 F.2d 304 (4th Cir. 1953); *Kirschenbaum v. Commissioner*, 155 F.2d 23 (2d Cir. 1946); *Smith v. United States*, 121 F.2d 692 (3d Cir. 1941). See also Samuel H. Kessner, 26 T.C. 1046 (1956) for a discussion of both tests.

⁵⁶ Treas. Reg. § 1.302-2(b) (1955).

⁵⁷ See Roeder, "Distributions in Redemption of Stock," N.Y.U. 15th Inst. on Fed. Tax 475 (1957). For a contrary view see Laikin, "Stock Redemptions: Sections 302 and 318," N.Y.U. 14th Inst. on Fed. Tax 671 (1955).

⁵⁸ See Roeder, *supra* note 57, at 480 for a discussion of the attribution rules.

The attribution rule which most directly effects the subject of inquiry is section 318(a)(2)(A).⁵⁹ Under this provision the beneficiary and the estate are treated as one for the purposes of determining the tax ramifications of a stock redemption. An example will be helpful to illustrate how the section works. If a corporation has 100 shares, 50 owned by the father and 50 owned by the son, and the father dies with the corporation redeeming the 50 shares from his estate, this will not qualify as a complete termination of the estate's interest, assuming that the son is a beneficiary of the father's estate. The stock of the son is combined with the stock of the estate; thus, the estate has sold out only 50% of its interest. The estate owns 100 of the shares both before and after the redemption (counting the shares owned by the son) so the plan will also fail under "substantially disproportionate" provisions.⁶⁰

Dividend treatment will result in the entire redemption price being taxable as ordinary income to the estate assuming sufficient earnings and profits under section 316 of the Code, and thus in many cases will completely destroy the effectiveness of the stock redemption agreement. There have been several suggested ways to circumvent the attribution rules and thus attain capital gain treatment and probably no tax on the basis of a complete sell-out. One suggestion frequently made to sidestep the father-son situation is to provide for payment of the son's legacy prior to the redemption in the father's will. Another suggestion has been to bypass the son and provide for the children of the son in the will but this raises the unanswered question of whether or not the stock of the son will be attributed to the children and then to the estate. Or the father can provide for the son in ways that will not result in the son being a beneficiary such as joint ownership, life insurance or an inter-vivos trust.⁶¹ Another suggested method of avoiding the attribution rules is for the father and

⁵⁹ This section reads as follows:

Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

⁶⁰ Rev. Rul. 56-103, 1956-1 Cum. Bull. 159 reached the same result. The ruling stated that the absence of a plan to avoid tax was not decisive and also that the fact of an agreement between the corporation and the decedent had no significance in determining whether or not the redemption was essentially equivalent to a dividend.

⁶¹ Under Int. Rev. Code of 1954, § 318(a)(2)(B) the constructive ownership rules will not be applied if the beneficiary's interest in the trust is a remote contingent interest. The beneficiary's interest is remote if it is 5% or less of the value of the trust property. Whether or not an interest is contingent will probably be governed by local law.

son to enter a cross-purchase agreement under which the son himself buys the stock from the father's estate.⁶²

It might be mentioned in passing that regardless of the attribution rules, at least partial relief can often be obtained under section 303 of the Code. If the federal estate tax value of the stock is equal to at least 35% of the gross estate, or 50% of the taxable estate of the deceased stockholder, the estate qualifies for non-dividend treatment under section 303. Under this section there may be redeemed with complete dividend immunity sufficient stock to pay the estate and inheritance taxes, and the funeral and administration expenses of the deceased stockholder.⁶³ This can be a substantial benefit, but in many cases dividend treatment on redemption proceeds is a serious risk and every stock redemption plan should be drafted with an eye toward this limitation.

REDEMPTION PRICE AS ESTATE TAX VALUATION

It is generally assumed that the price paid for the stock on redemption will fix the valuation of the stock for federal estate tax purposes. This is not necessarily true and there are some fairly definite rules to be followed in order to insure that the price set will be used for purposes of estate tax valuation.⁶⁴

In order for the agreed price to be binding on the Internal Revenue Service, there must be restrictions on the right of the owner of the stock to transfer it during his life.⁶⁵ Furthermore, the stock-purchase agreement must bind the estate to sell at death if the purchaser desires to purchase the stock. Giving the purchaser a right of first refusal is not enough if the estate is not obligated to sell the stock.⁶⁶ The estate tax regulations provide that the agreement must be the result of arm's-length dealing and requires consideration in money or money's worth.⁶⁷

The sufficiency of consideration is measured at the time of the

⁶² See Friedman and Wheeler, Jr., "Stock Redemption Agreements Funded by Life Insurance," 37 *Taxes* 915, 921 (1959).

⁶³ For a discussion of section 303, see Lanahan, "Redemptions to Pay Death Taxes: Redemptions Through the Use of Related Corporations (Sections 303, 304)," N.Y.U. 15th *Inst. on Fed. Tax* 493 (1957).

⁶⁴ For a comprehensive discussion of this problem see Comment, "The Use of Life Insurance To Fund Agreements Providing for Disposition of a Business Interest at Death," 71 *Harv. L. Rev.* 687, 690 (1958).

⁶⁵ *Estate of James H. Matthews*, 3 T.C. 525 (1944), acq. 1944-1 *Cum. Bull.* 19; *Treas. Reg.* § 20.2031-2(h) (1958).

⁶⁶ *Michigan Trust Co.*, 27 B.T.A. 556 (1933).

⁶⁷ *Treas. Reg.* § 20.2301-2(h) (1958). The consideration is presumed to exist between strangers but it will not be presumed to exist in dealings between the decedent and the natural objects of his bounty.

agreement so that it is not decisive if a difference exists between the price set and the market value of the stock at the time of death.⁶⁸ However, a great disparity may show lack of good faith at the date of execution, and for this reason a clause providing for periodic re-evaluation should be inserted or the formula method of price setting should be used. This is especially true if related parties are involved since transactions between them will always be scrutinized more carefully.⁶⁹

If the requirements mentioned are followed at the time the agreement is drawn up, the value set by the stock purchase agreement should be determinative of the stock value for estate tax purposes.

STATE LAW PROBLEMS

It should be noted in passing that before consummating a stock redemption plan state laws should be consulted for statutory provisions or case law in the areas of insurable interest⁷⁰ and the right of a corporation to purchase its own stock.⁷¹

In general it is stated that a corporation has an insurable interest in the lives of its officers especially if they are persons upon whom the business is dependent for its continued success.⁷² Several cases may still be found, however, holding that a corporation has no insurable interest in its officers or directors.⁷³

Now only a few jurisdictions still retain the minority rule forbidding a corporation to purchase its own stock.⁷⁴

The majority of American courts have taken the view that a solvent corporation may purchase and hold its own stock without

⁶⁸ Edith M. Bense, 36 B.T.A. 246 (1937), *aff'd*, 100 F.2d 639 (3d Cir. 1938); Treas. Reg., *supra* note 67.

⁶⁹ Edith M. Bense, *supra* note 68.

⁷⁰ See generally 2 Appleman, "Insurance Law and Practice," §§ 871, 872 (1941, Supp. 1957).

⁷¹ See G. A. Fletcher, "Private Corporations," §§ 2845-61 (perm. ed. rev. repl. 1950).

⁷² *Keckley v. Coshocton Glass Co.*, 86 O.S. 213, 99 N.E. 299 (1912). For cases from other jurisdictions see Appleman, *supra* note 70, at 260.

⁷³ *Victor v. Louise Cotton Mills*, 148 N.C. 107, 61 S.E. 648 (1908) (holding that corporation has no insurable interest in its president). *Security Mutual Life Ins. Co. v. J. M. Schott & Sons, Co.*, 30 O.C.C. 656 (1909) (holding corporation has no insurable interest in its director). A later Ohio case, however, has upheld a corporate owned key-man life insurance policy on the life of the President. *Finney v. Hinkle*, 106 Ohio App. 89, 153 N.E.2d 699 (1958). See also *Keckley*, *supra* note 72 which in effect overrules the earlier 1909 Ohio case by holding that a corporation has an insurable interest in a person who is the owner of a large portion of the stock of the corporation.

⁷⁴ *Latulippe v. New England Invest. Co.*, 77 N.Y. 31, 86 Atl. 361 (1913); *Pace v. Pace Bros. Co.*, 91 Utah 132, 59 P.2d 1 (1936).

authority, in the absence of express restrictions, provided it acts in good faith and without prejudice to the rights of creditors and has a surplus with which to make the purchase.⁷⁵

CONCLUSION

There are certain precautions which must be observed in the area of stock-purchase agreements funded by life insurance. The law is fairly clear and this is all the more reason for following it to the letter both in the planning stage and in the drafting stage.

The corporation should have a valid business purpose for purchasing the stock and this purpose should be recorded in the corporate minutes. If the corporation gives the insured the right to choose a beneficiary, the corporation should reserve the right to change the beneficiary and should also retain all other incidents of ownership in the policy. The corporation should set the insurance up as an asset subject to the claims of creditors. If at all possible the redemption should be arranged so that it does not result in dividend treatment to the estate under section 302. The agreement should be integrated with other planning devices so as to avoid the attribution rules of section 318 of the Code. This checklist is not intended to be exhaustive but only to mention some of the more obvious problems.⁷⁶

The tax problems of a stock purchase agreement are increased when the entity plan is used rather than the cross-purchase plan, but in many cases the practicalities of the situation require the corporation to be the purchaser of the stock. In the present state of the law the corporate buy-out plan will in most cases be perfectly feasible. However, there are many tax pitfalls which must be recognized at the outset in order to avoid disastrous results.

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⁷⁵ See Fletcher, *supra* note 71, at 364. The governing Ohio statute is Ohio Rev. Code § 1701.35, subdivision B of which states as follows:

A corporation shall not purchase its own shares except as provided in this section, or if after such purchase its assets would be less than its liabilities plus stated capital, or if the corporation is insolvent, or if there is reasonable ground to believe that by such person it would be rendered insolvent.

See subsection A for the restrictions on a corporation buying its own stock.

⁷⁶ See Worthy, "Current Developments in Federal Taxation Affecting Life Insurance," A.B.A. Sect. Ins. N. & C. L. 142 (1958), for a more complete list of precautions to take in preparing stock-purchase agreements funded by life insurance.